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ABSTRACT

The booklet explores various roles which money has played throughout history and examines the relationship between money and the Federal Reserve System. The major objective is to increase understanding of the performance of various functions such as making money work as a medium of exchange and as a measure of value and of storing value for future use. Topics discussed include the barter system as the ancestor of money, early and modern forms of money, disadvantages of coin, commercial banking, influences of banks of the money supply, bank lending, the price of borrowed money, problems of money and banking systems, monetary policy, bank reserves, Federal Reserve processing services, and the cost of operating the Federal Reserve. Information is presented in a statement/explanation format and is accompanied by illustrations and photographs. (DB)

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Your Money and the Federal Reserve System

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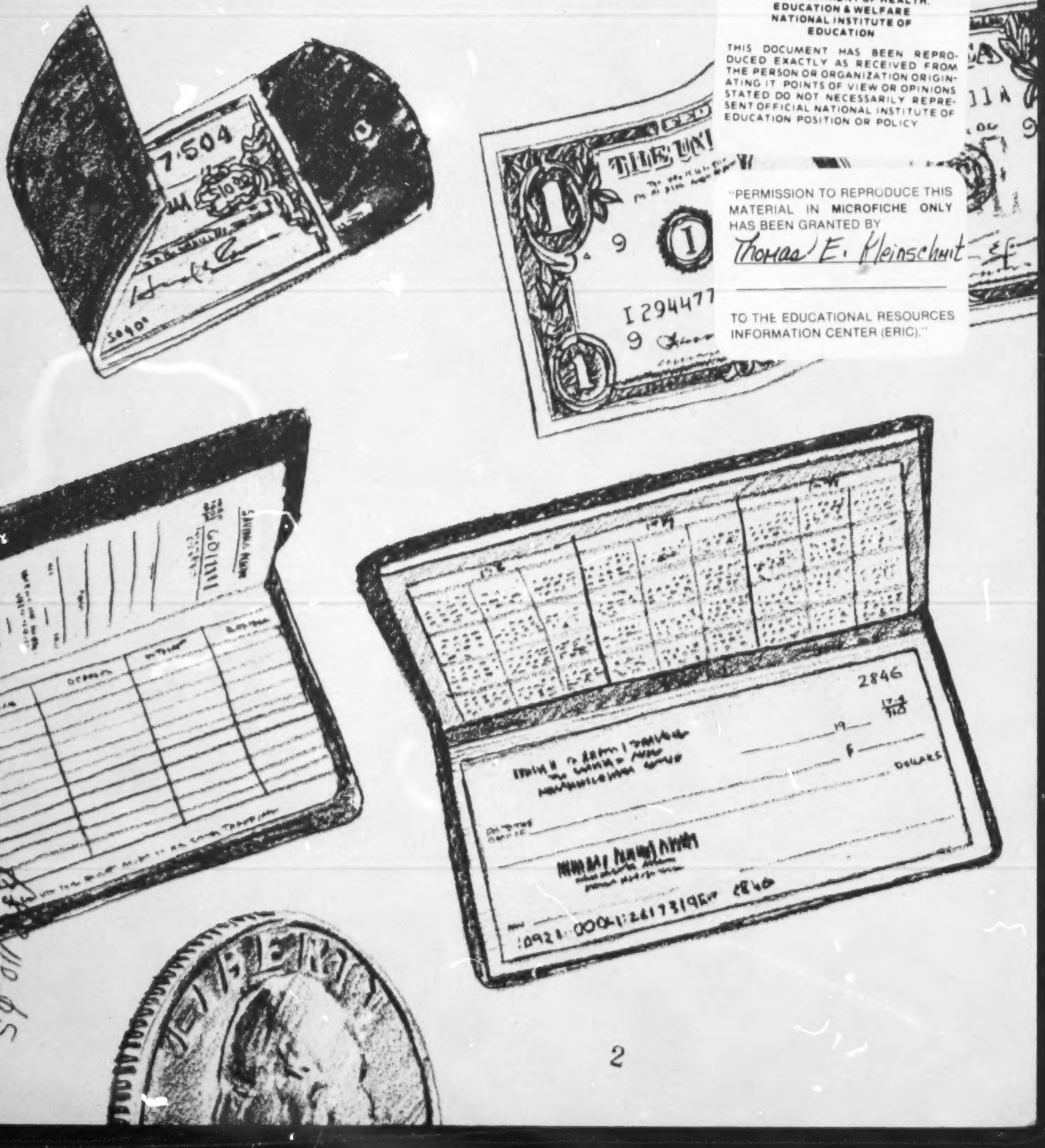

Your Money and the
Federal Reserve System

Federal Reserve Bank of Minneapolis

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Some things never change. Primitive cultures had many of the same needs we have today—for what we now call "money."

They needed a way to trade the things they made or raised or hunted for other things they wanted. They needed a way to measure the value of things. They needed a way to save or store the value of what they produced, so that value could be used or exchanged later on. They needed money.

We're still working on better ways to perform these functions—making money work as a medium of exchange, a measure of value, and to store value for future use.

Without money we must barter

The ancestor of money was the barter system—where one product or service was exchanged for another. Barter would be a cumbersome way of doing business in today's world. For example, how many cows would an automobile dealer take in exchange for a car? Perhaps the car manufacturer would prefer horses. Then the dealer would have to exchange cows taken in trade for horses. Our ancestors found they were wasting a lot of time arranging trades, time that could better be spent producing things—so they sought a better method of exchange.

Minnesota Historical Society

Early forms of money

As an improvement on barter, certain popular, measurable commodities came to be used as *mediums of exchange*. Standard items such as salt, tea, pelts, beads, cattle, or grain had general acceptance in trade and were used as money. Thus, a person could "buy" something with a widely-accepted commodity. And the seller in turn could trade that same commodity for his own purchases. This system was an improvement over direct barter, but was still cumbersome. Besides, not all commodities could be stored for future use.

Coins serve as money

Primitive man began to use metals—particularly gold and silver—in place of commodities as forms of money. Metals provided a measure of value and were easily stored or saved for future use. Metal could also be formed into coins or tokens of different sizes with different values. Early coins carried likenesses of kings and emperors, just as modern coins carry images of political leaders.

Disadvantages of coin

While coins possess the basic qualities that people require of money, they have two major faults. They are not convenient to carry in large amounts and, more important, the supply of coins is limited to the metals available. With coins the money supply depends on random forces such as silver and gold discoveries, rather than on the needs of commerce, industry and agricultural production. Thus, money developed two new requirements—it had to be easy to carry and the supply must be flexible to keep pace with changing economic needs. The *usefulness* of money became more important than the substance it was made from.

Modern forms of money

Money today consists of coins, paper currency, and bank checking deposits called checkbook money. We use coins to deposit in vending machines, for small purchases or to make change. Paper money is used to pay for things that have higher prices. We're more apt to use checks drawn on bank accounts to settle business dealings.

Still there are inherent problems with these modern forms of money. They still require physical movement of cash or checks from buyers to the sellers. That's often inconvenient, and it's costly. It costs a great deal to process and collect the more than 24 billion checks that Americans currently write each year.

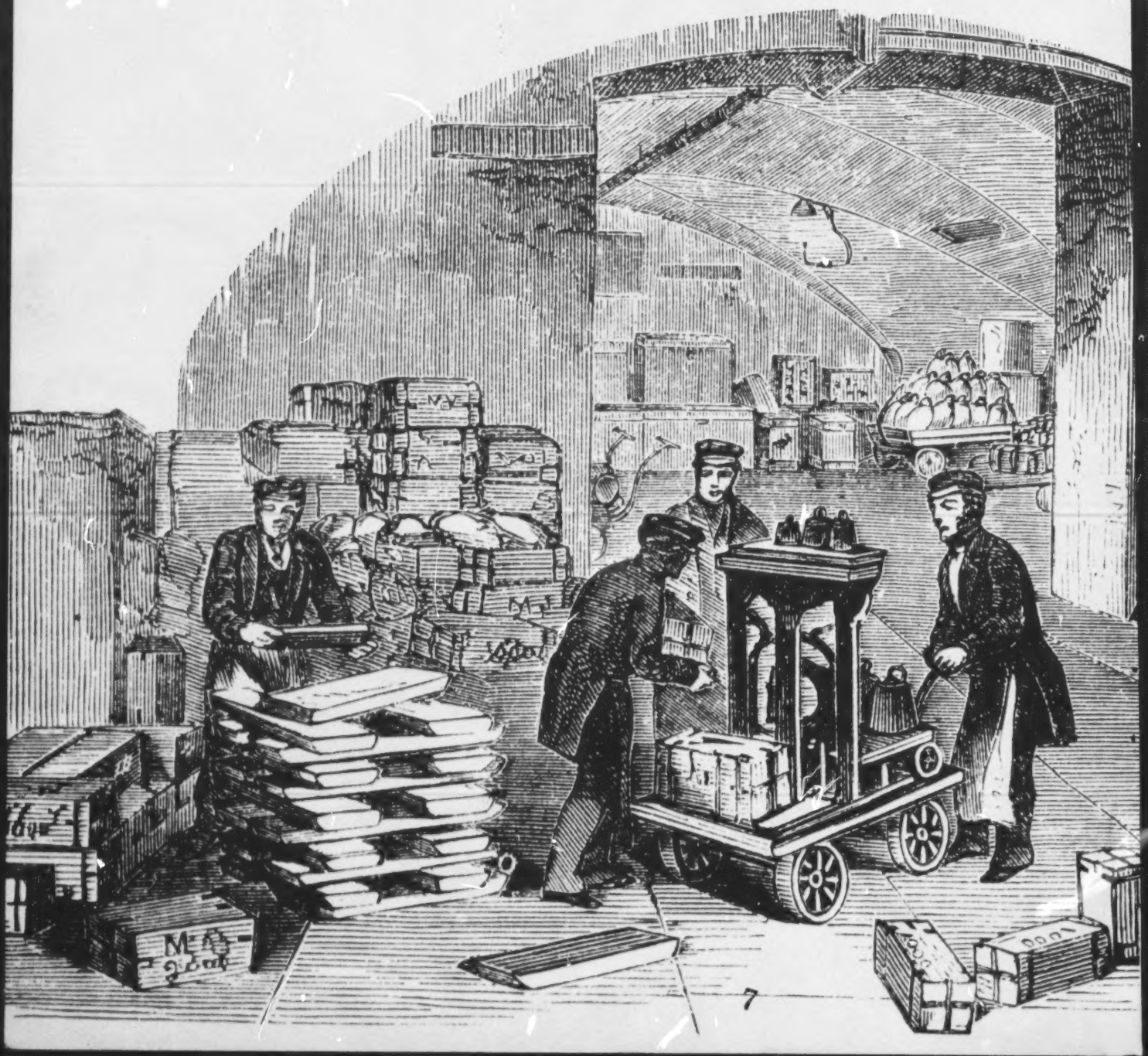
Now we're beginning to make electronic transfers of money. Electronic transfers don't require the physical movement of cash or checks. When a buyer makes a purchase, funds are transferred by keypunched entries at a computer unit rather than by writing a check. As electronic payment systems become more sophisticated and widely used, there'll be less need to carry cash or to process checks to pay for purchases.

Modern forms of money possess the three qualities which our ancestors sought and which we need today—a medium of exchange, a measure of value, and a means to save or store purchasing power. Moreover, the development of our central banking system allows the supply of money to expand or contract to meet the changing needs of our economy.

Commercial banking begins

Although archeologists have uncovered stone tablets that apparently served as loan contracts in ancient Babylon, modern day banking probably had its start in England. Goldsmiths stored gold and coins for customers as a sideline to their principal trade. Smiths accepted customers' gold for deposit and issued receipts for the amount. In time, depositors of gold found they could settle debts by transferring gold receipts instead of gold itself—it was easier and also safer. So people transferred gold receipts in much the same way we pay with checks written on our deposit in a bank.

Goldsmiths soon discovered that part of the money left with them was never withdrawn. They could loan it to other persons who would repay later, with interest. Furthermore, the borrowers found it convenient to accept receipts for the amount of their loans rather than actual gold. The receipts were used as money and were lighter and safer. This change in the role of goldsmiths, from custodians to lenders, marked the beginning of commercial banking as we know it today.



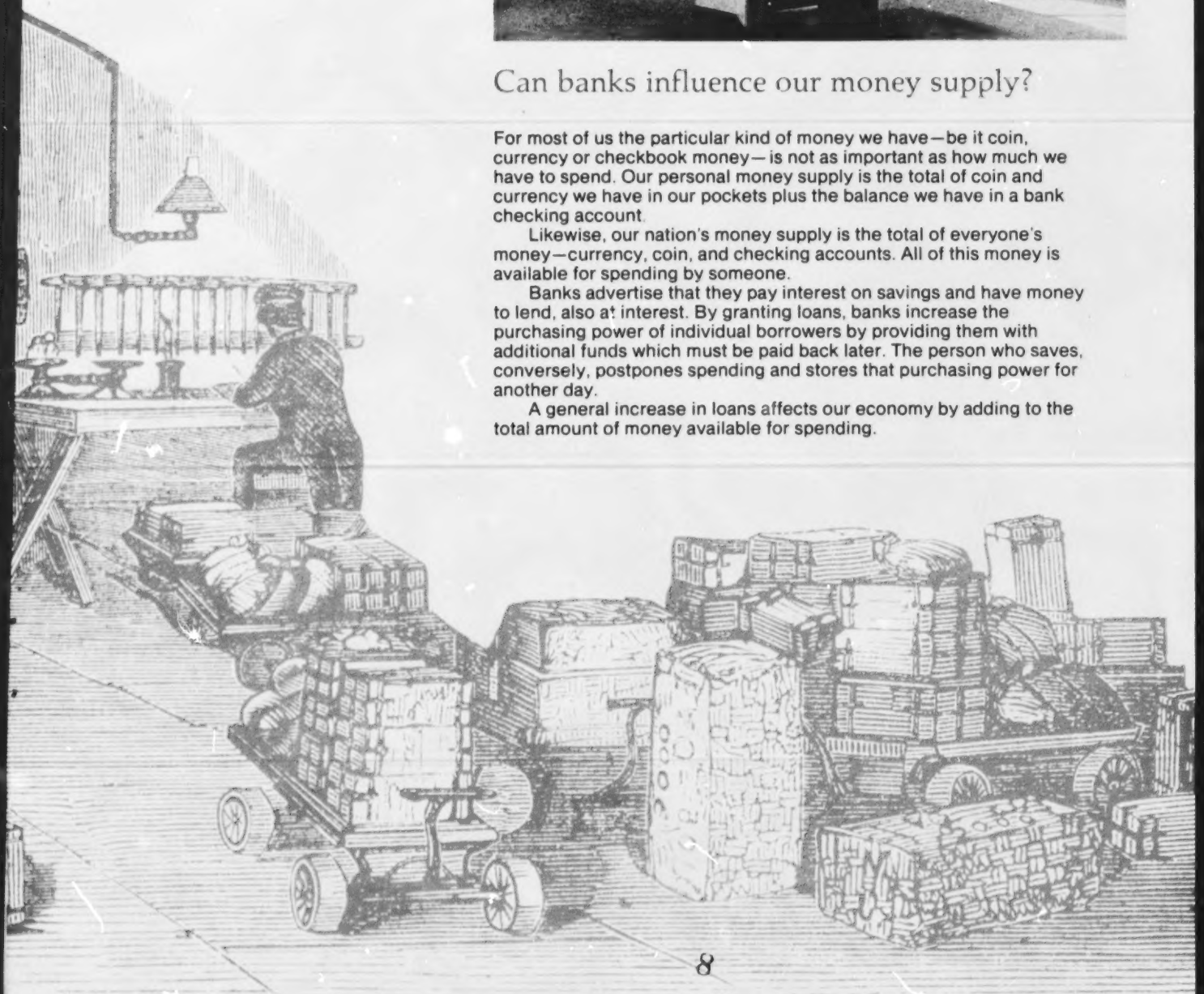
Can banks influence our money supply?

For most of us the particular kind of money we have—be it coin, currency or checkbook money—is not as important as how much we have to spend. Our personal money supply is the total of coin and currency we have in our pockets plus the balance we have in a bank checking account.

Likewise, our nation's money supply is the total of everyone's money—currency, coin, and checking accounts. All of this money is available for spending by someone.

Banks advertise that they pay interest on savings and have money to lend, also at interest. By granting loans, banks increase the purchasing power of individual borrowers by providing them with additional funds which must be paid back later. The person who saves, conversely, postpones spending and stores that purchasing power for another day.

A general increase in loans affects our economy by adding to the total amount of money available for spending.



We borrow to buy

Money is borrowed for many purposes—such as to buy a car or a home, to pay for medical services, to purchase raw materials for manufacturing, to pay employees or to stock inventories.

When individuals, businesses and governments borrow more money, they increase their purchasing power and also the demand for goods and services in the economy.

More bank lending means more demand for goods and services in the economy; less lending means less demand.

In the United States, the Federal Reserve System has the power to encourage or discourage lending by banks. Thus it influences the level of spending and production in our economy.

CUSTOM VAN

STICKER PRICE	$6,800
LESS TRADE-IN	− 1,000
LESS DOWNPAYMENT	− 1,000
AMOUNT OF LOAN	$4,800

NUMBER OF PAYMENTS ≈ 78
PAYMENT PER PERIOD ≈ $69
FINAL PAYMENT ≈ $4
FINANCE CHARGE ≈ $517
TOTAL OF PAYMENTS ≈ $5,317

The price of borrowed money

Most of the time we think of money in terms of what it will buy. But money also has its own price and can be bargained for the same as any other commodity. Banks and others having money to lend expect to be paid for its use. People who invest their money (savings) also expect to earn something. The amount lenders charge (subject to some restrictions imposed by law) is determined by how much they have to lend and the amounts the borrowers are willing to pay. That charge, or price, is called *interest*.

Interest rates increase or decrease with changes in demand for money and with changes in the supply of money available to borrow. For example, when borrower demand increases, interest rates tend to go up; when demand decreases, interest rates tend to go down. Similarly, when lenders' supplies of money increase, interest rates tend to decline; and when supplies decrease, rates tend to go up. Thus, the price of money—interest—like the price of commodities, changes with supply and demand conditions.

Early problems of our money and banking systems

Before there was a Federal Reserve System, the United States money system did not always serve the economy well. Supplies of money could not readily adjust in response to changes in business activity.

As a result, banks often found themselves short of currency. Bank depositors had a legal right to withdraw their money in the form of currency or coin if they chose, and banks provided for ordinary withdrawals by retaining part of their total deposits as reserves. These reserves were partly currency and coin, and partly deposits in other banks which could be exchanged for currency.

Sometimes demand for currency was greater than the supply of money kept on hand by a bank. Then the bank sought currency by drawing on its deposits in other banks, or by selling bank assets. Such action all too frequently caused a chain reaction of currency shortages in a number of banks.

Banks unable to meet unusual depositor requests for currency "failed" and were forced to close. In many instances, banks that failed were perfectly sound, and their assets could have been converted into currency if they had had enough time. Unfortunately, panicky depositors lost confidence in the banks and would not postpone their demand for currency. Bank closings brought on periods of economic depression called "money panics."

In response to the 1907 panic, Congress began a thorough study of our money system. The study found that nearly all countries whose currency supply could expand or contract in response to depositor demands (an "elastic" currency) had some form of central bank. These central banks had the power to issue currency in the quantity needed. As a result of this and other studies, the United States Congress passed the Federal Reserve Act in 1913, creating the Federal Reserve System.

Minnesota Historical Society

What is the Federal Reserve System?

Since 1913, the Federal Reserve System has functioned as the central bank of the United States. Its chief job is monetary policy—to manage the supply of money and credit in the best interests of our national economy.

Founders of the Federal Reserve System were concerned that the power to control the money supply not serve political interests. Such power must serve all citizens.

The System is composed of a central Board of Governors located in Washington, D.C.; and 12 regional Reserve Banks serving geographic districts. District Bank presidents work with the Board of Governors to determine central bank policy. This assures that each region's interests are represented when decisions are made at the national level.

The Board of Governors oversees Reserve Bank operations and issues banking regulations. The Board's seven members are appointed by the President and confirmed by the Senate. They serve 14-year terms.

Each district Reserve Bank is governed by nine directors: three bankers, three representatives of business, commerce, or agriculture, and three members selected to represent the general public.

All national banks are required to be members of the Federal Reserve System. State chartered banks can be members by choice. All member banks participate in the election of their district Bank's board of directors.

Monetary policy function

As central bank, the Federal Reserve System manages the money supply of the U.S. by influencing the lending activity of commercial banks, which in turn affects the level of spending and production in our economy. This is called monetary policy.

When banks make more or fewer loans, they affect the amount of spendable money all of us have; thus the Federal Reserve System's influence on bank lending is an important tool of monetary policy.

Each month, five presidents of the regional Reserve Banks meet with the Board of Governors to discuss and act on monetary policy. The five presidents, who serve on a rotating basis, and the Board of Governors constitute the Federal Open Market Committee (FOMC) which is the policy making body that sets guidelines for managing the availability of money and credit on a day-to-day basis.

By stimulating or discouraging demand for goods and services, the FOMC can moderate the degree of inflation or recession in our economy. For example, if inflation threatens, the FOMC can follow a "restrictive" monetary policy which will make it harder for consumers, businesses and governments to borrow money to buy more goods and services. This action to lessen the demand for goods lessens inflationary pressure on prices.

On the other hand, if the economy is in a recession, the FOMC may act to increase the money supply—to increase demand and thus stimulate the economy.

Developing monetary policy is an ongoing process. It requires continuous monitoring of the economy. Each month when the FOMC meets, members examine such factors as the level of unemployment, the rate of inflation, interest rates, the levels of bank reserves and bank borrowings, the overall money supply, plus current saving and spending. They also look at international trade and international money flows and exchange rates. After this review, FOMC members decide the best monetary policy to follow to improve the strength and efficiency of our economy.

This ongoing process is repeated every four weeks and is directed toward four main objectives: FULL EMPLOYMENT, ECONOMIC GROWTH, STABLE PRICES and a satisfactory BALANCE OF PAYMENTS in our international trade. Understandably, monetary policy cannot serve these objectives at the same time, and sometimes hard choices and compromises must be made. Nevertheless, FOMC members strive to set policy that will help achieve these combined objectives.

FOMC

Market brightens as the Fed makes moves to loosen credit

NEW YORK, N.Y. (AP) — The stock market got off to a dreary start this week, but then staged a strong comeback amid hopes that the Federal Reserve would relax its credit policies.

The net result was a modest decline in continued sluggish trading.

The Dow Jones average of 30 industrials, down 34 points in the week's first three sessions, had cut its loss to only 5.39 by yesterday's close.

COMPARABLY MINOR declines were posted by Standard & Poor's 500-stock index, off .24 at 85.95, and the New York Stock Exchange composite index, down .21 at 45.49.

Losers outnumbered gainers 1,109 to 605 among the 1,999 issues traded on the Big Board.

A gloomy mood was set Monday morning when Treasury Secretary warned that the gap and be-

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pensive to borrow, prospects for a solid recovery from the recession were likely to dim.

BY WEDNESDAY'S close, the Dow had reached its lowest level since early April at 784.16.

The market picture began to brighten Thursday, however, when New York State's comptroller, Arthur Levitt, agreed to commit $25[0] million in pension funds to debt s[e]curities designed to provide New York City with enough cash to s[ur]vive it through mid-December.

After Thursday's close, weekly Federal Reserve statistics showed continued lag in the nation's mo[ney] supply.

This decline in the amount cash got a warm reception on Wall Street because of its implications for Federal Reserve policy.

If the money supply was s[low]ing, the Fed theoretically

going on credit while still efforts.

Oil cartel sets 10-pct. price rise

Monetary policy . . . regulating the money supply

Federal Reserve monetary policy influences bank lending—and thus our money supply—by influencing the reserves of commercial banks.

Banks that are members of the Federal Reserve are required to set aside a percentage of their deposits as reserves with their district Reserve Bank.

We have seen that expanded loans at commercial banks increase the money supply—by adding to checking deposits in banks. And because required reserves are only a small fraction of deposits, each dollar of new reserves can support several dollars of new deposits (and new loans) in the banking system.

Therefore, by increasing or decreasing the amount of reserves in the banking system, the Federal Reserve alters the potential volume of checking deposits that banks can create by making loans.

The Federal Reserve affects bank reserves in three ways: first, it sets the percentage of reserves that member banks are required to maintain. If banks are permitted to maintain a smaller percentage of their deposits as reserves at the Fed, it means that each reserve dollar can support more deposit dollars. Banks can make more loans and create deposits until the new reserve ratio is reached.

Raising the percentage of required reserves means that each reserve dollar can support fewer deposits in the banking system; deposits will have to be reduced to meet the new ratio of required reserves to deposits. To do so, loan volume will have to be reduced.

Second, each Reserve Bank can lend funds to member banks and thus increase bank reserves. The Federal Reserve determines the discount (interest) rate which banks must pay for such loans. It usually grants loans when banks are faced with temporary or unusual operating needs.

Third, the Federal Reserve most frequently adjusts the level of bank reserves by buying or selling U.S. government securities on the open market—known as *open market operations.*

Open market operations

To lower the level of bank reserves, the Federal Reserve sells government securities that it owns, normally to established security dealers. Dealers pay for securities with checks drawn on commercial banks. To collect these checks, the Federal Reserve charges the reserve accounts of the banks. This reduces reserves in the banking system.

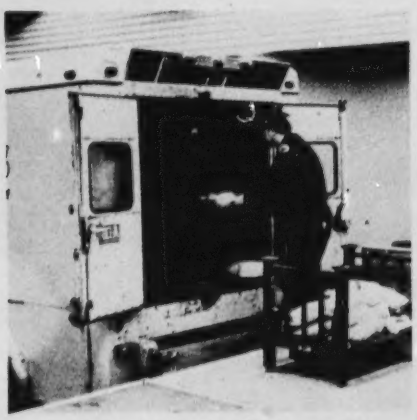
If the Federal Reserve wishes to increase bank reserves, it buys government securities and gives Federal Reserve checks to sellers. Sellers deposit these checks in their banks which in turn deposit the checks with the Federal Reserve. To pay the checks, the Federal Reserve increases the reserve accounts of depositing banks. Thus, reserves in the banking system are increased.

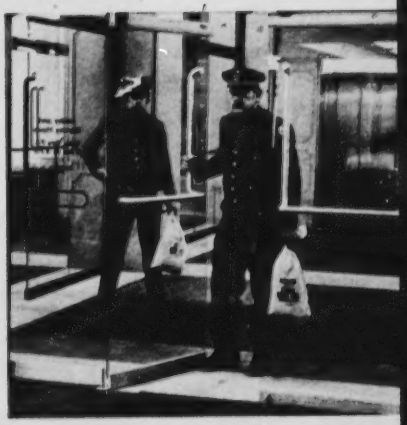
The Federal Open Market Committee sets guidelines and objectives for open market operations. Actual day-to-day purchases or sales of securities are made through the Federal Reserve Bank of New York.

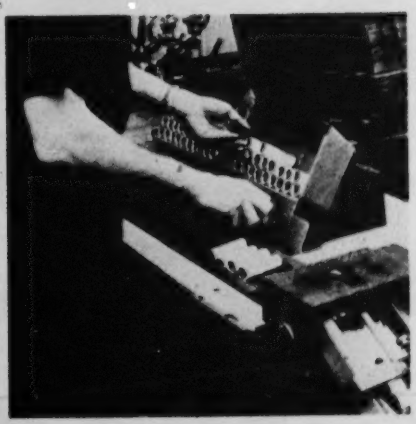
The Federal Reserve provides currency and coin

Federal Reserve Banks also provide currency and coin for banks. When a member bank needs additional currency and coin to supply its customers, it orders from the Reserve Bank and pays by drawing on its reserve account at the Reserve Bank. When a member bank accumulates more currency or coin than it needs, it ships its excess to the Reserve Bank and gets credit in its reserve account.

In order to maintain the condition of coin and currency, Reserve Banks replace worn or damaged currency and coin with new money—obtaining coin from the U.S. mints and new currency from the Bureau of Engraving and Printing in Washington, D.C.







Federal Reserve processing services

Americans today are writing over 24 billion checks annually. These checks are orders by depositors drawn on their banks to transfer funds. They may pay for goods and services bought locally or in other parts of the country. A person receiving a check wants it presented for payment as quickly as possible, because any delay will postpone the time when money represented by the check can be used.

When a check is written in or near the community of the bank on which it is drawn, presentation for payment is direct—local banks just exchange checks among themselves. It's estimated, however, that more than half of all checks leave the local community. Banks receiving checks drawn on distant banks find it costly and inconvenient to return such checks directly for payment. Instead, banks that are members of the Federal Reserve, use check collection services at district Federal Reserve Banks, where checks for many banks are cleared at the same time. Some are presented by member banks, some are presented by the Treasury of the United States or other government agencies, and some are received from other Federal Reserve Banks.

Check Departments at the Reserve Banks use modern electronic equipment to sort and deliver checks for payment as quickly as possible. They send checks directly to banks located in their own reserve district and send checks drawn on banks in other districts directly to the Federal Reserve Bank serving those banks. The receiving Reserve Bank, in turn, forwards checks to the banks in its district on which they are drawn. Reserve Banks give deposit credit for the checks received from member banks, and must obtain payment from banks on which checks are drawn. For payment, the Reserve Bank may charge the reserve account of the paying bank directly, or through another bank.

Route of a check

Minneapolis resident buys tickets for New York Jets game

Sends check drawn on Minneapolis Nat'l. Bank to Jets' office

Jets mail tickets and deposit check in New York Nat'l. Bank

New York Nat'l. Bank sends check to New York Federal Reserve

New York Federal Reserve sends check to Minneapolis Federal Reserve

Minneapolis Federal Reserve sends check to Minneapolis Nat'l. Bank

Minneapolis Nat'l. Bank deducts check from Minneapolis resident's account

Cancelled check returned to Minneapolis resident

Who pays the cost of operating the Federal Reserve?

When Federal Reserve Banks were established by Congress to perform central bank functions in the public interest, provision was made to shield them from political influence. Unlike traditional federal agencies, the Federal Reserve receives no budget appropriations from Congress. Instead Reserve Banks earn their own income from:

- interest on government securities purchased and held by the Federal Reserve System,
- interest they receive on loans granted to member banks.

At the end of each year, Reserve Banks return to the U.S. Treasury all earnings in excess of those used to pay for Reserve Bank operations. In recent years, the expense of operating Reserve Banks has been less than 9% of total earnings. Thus, over 90% of gross earnings are transferred to the Treasury each year.

Services . . . the Federal Reserve serves the government

Our government buys goods and services—a lot of them—the same as businesses and individuals. So, the government needs banking services to assist its transactions. It uses the services of Federal Reserve Banks much as private businesses use services of commercial banks.

All checks drawn on the Treasury of the United States are paid at Federal Reserve Banks. Each year, billions of dollars are deposited by various government agencies such as the Internal Revenue Service—then billions of dollars in checks are written against these deposits. Since the government ranks as the country's biggest business, handling its bank account is an important task.

Sometimes the government borrows to have enough money for its payrolls, purchases and other expenses. To borrow money, the Treasury sells its securities to individuals, banks, dealers and other investors. Treasury Bills are short term securities maturing in three months, six months or one year. Treasury Notes are payable in seven years or less, and Treasury Bonds are payable at maturities after seven years. U.S. Savings Bonds, sold primarily to individuals, also represent Treasury borrowing.

When the Treasury borrows money or pays off maturing debt, Federal Reserve Banks perform these transactions for their district providing a vital link between the public and the Treasury.

Money alone cannot produce the things we want and need; it can only pay for them. Prices in our economy depend on both the supply of money and the ability to produce goods and services. If more money is available without an increase in production, prices go up. If more goods and services are available without an increase in the money supply, prices go down. Thus prudent management of our money supply is a vital responsibility.

Money today is an acceptable medium of exchange, a measure of value for buyer and seller, and a means of storing value for future use. Future improvements in our money system will reflect changes in technology such as electronic money, and hopefully, a better understanding of how our economy works.